

## **Testimony Before Michigan Senate Finance and House Tax Policy Committees**

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Madam and Mr. Chairman and Members of the Committees:

Thank you for the opportunity to address you today. By way of background, I am currently President of Hillsdale Policy Group, and the George Munson Professor of Political Economy at Hillsdale College. I received my Ph.D. in economics from the University of California at Berkeley, and have taught at various colleges prior to my coming to Hillsdale College. From 1983 to 1989 I served as the senior economist for the Senate Majority Policy Staff, and director of the staff of the Senate Finance Committee. I served as Deputy State Treasurer for Taxation and Economic Policy in the first Engler administration, and Congressman Nick Smith's Washington chief of staff in the 104<sup>th</sup> Congress.

I would like to discuss two issues. First is to briefly review Pat Anderson's report, *The Tax Burdens of Michigan's Single Business Tax*, which the joint committee received last week. Second, I would like to briefly discuss some salient points regarding the Governor's tax proposal, particularly its effect the Michigan economy in terms of providing jobs.

Mr. Anderson does a very good job of sorting out the tax base of Michigan's SBT by industry. He finds that the Governor's tax proposal is close to revenue neutral, ignoring the effect of the retaliatory tax increase that Michigan's home-based insurance companies will face in other states, and the tax increase caused by the change in rules for property tax assessments of commercial property. While I believe he has underestimated the tax increase effect of the triple-weighting of corporate profits, reasonable persons may disagree and am willing to accept his conclusion that "because the change is within the precision of our estimate, we consider the SBT changes to be revenue neutral."

What Mr. Anderson's study then actually shows is that the Governor's proposal is a tax increase. If Michigan were to increase its tax on the insurance industry by levying a 2 percent sales tax on insurance premiums, as in the Governor's proposal, Michigan firms would be faced with an automatic increase in the taxes they pay to other states. This could be as high as \$75 million. (One company's taxes paid to other states would increase by \$9 million.) In addition, the proposed change in how occupancy rates affect true cash value of commercial property would raise property taxes by \$60 million per year and this also is not included in Pat's estimate. Finally, there will be a tax increase due to the changes in the treatment of LLC's under Section 108 of SB 298 (the old MCL 208.36), whereby compensation limits will become binding, and there is a change in the

tax treatment of Professional Employer Organizations under Section 110, that will increase taxes. None of these tax increases is accounted for in the methodology of the Anderson study. In total, then, the proposal is a tax increase on Michigan companies.

As I noted, I believe that the Anderson study underestimates the tax increase of the Governor's proposal, aside from the elements not included in his study. My main disagreement is with his assumption (see page 22) that "business income and corporate profits grew by 6% between 2000 and 2006." This is a key assumption, due to the provision that corporate profits will now be triple weighted in the base. The *Economic Report of the President* for 2005 shows that corporate profits nationwide rose by 25 percent from 2000 through 2004. Corporate profits are up in 2005 as well. This indicates that the Anderson report severely understates the growth in corporate profits and thus understates the tax increase that will result from triple weighting of corporate profits in the tax base.

I am in agreement with the Anderson Report that Michigan has a high state tax burden. CNN/Money in 2005 published an article, "How Tax Friendly is Your State." It found that Michigan had the 13<sup>th</sup> highest tax burden on individuals, including state and local taxes and the percentage of business taxes passed on to consumers. The U.S. Census Bureau ranked Michigan as the 11<sup>th</sup> highest state in state taxes per capita for 2004. As a percentage of personal income, Michigan ranked 9<sup>th</sup> highest in 2002. While our overall state tax burden is high, our tax on business is particularly burdensome. The Tax Foundation, in its October 2004 Backgrounder Report, *State Business Tax Climate Index* (Hodge, et al., Number 45), ranked Michigan 50<sup>th</sup> among the states in its Corporate Income Tax Rank (pg. 4). According to *Governing Magazine*, using 2002 U.S. Census Bureau data, Michigan has the 4<sup>th</sup> highest taxes on business on a per capita basis and as a percentage of personal income.

Michigan's economy reflects this high tax burden. The latest U.S. Department of Labor numbers are indicative of our poor economic performance. In April, Michigan once again had the highest unemployment rate of any state in the country at 7.0 percent. This compares to the national rate of 5.2 percent. Michigan lost 30,600 jobs over the past twelve months. Only one other state lost jobs over the past 12 months--South Carolina, which lost 6,800 jobs. Over that same period Indiana gained 39,000 jobs, Illinois gained 43,000 jobs, and Pennsylvania gain 61,200 jobs. Michigan's unemployment rate was at a historic low of 3.2 percent in March of 2000. Over the past 4 years it went from below the national average to 35 percent above the national average. State Policy Research publishes an Index of State Economic Momentum. Michigan ranked 48<sup>th</sup> in the June 2004 index, down from 40<sup>th</sup> in the June 2001 index, and 50<sup>th</sup> in the most recent report.

Personal income data shows the same pattern. Personal income per capita growth was by far the lowest in the nation from 2003 to 2004. Michigan's personal income per capita rose by 2.5 percent, while the nation's rose by 4.7 percent. The next lowest rate of growth in the Great Lakes Region was Ohio with a 4.0 percent growth. Population numbers tell the same story. Michigan's population annual rate of growth from April 2000 to July

2004 was only 40 percent of the nation's growth, .4 percent to 1.0 percent. Forty-six percent of this difference in population growth can be explained by net loss of residents to other states.

As the Committee heard last week there is a wealth of economic studies that show the inverse relation between state tax burden and state economic growth. In one of the first of such studies, economists at the Harris Bank in Chicago did a simple regression analysis to show that state and local taxes had a negative effect on state economic growth. (Genetski and Chin, *The Impact of State and Local Taxes on Economic Growth*, Chicago: Harris Bank, 1978). An entire literature has followed that yielded similar results. Dr. Richard Vedder, the Ohio University economics professor who testified before this committee, has done a number of studies, including two for the Joint Economic Committee of Congress, that demonstrate that high and/or rising taxes reduce economic activity in a state. (Vedder, *State and Local Economic Development Strategies: A Supply Side Perspective*, Wash DC: JEC, 1981 and *State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform*, Wash DC: JEC, 1995.) James Hines published a paper in the *American Economic Review* in 1996 that found that state and local taxes had an adverse effect on the location of foreign investment in America. (Hines, "Altered States: Taxes and the Location of Foreign and Domestic Investment in America," *American Economic Review*, 1996.)

There is a growing literature that demonstrates that reducing taxes will actually increase state revenues. For a quick summary, I recommend The Heritage Foundation's Backgrounder, *The Laffer Curve: Past, Present, and Future*, by Arthur Laffer, No. 1765, June 1, 2004 and *The Historical Lessons of Lower Tax Rates* by Dan Mitchell, Heritage Foundation Webmemo #327, August 13, 2003.

If the committees wish to put together a tax proposal that creates jobs, it would not be the one contained in SB 296 and HB 4476, which will increase taxes on Michigan firms by Treasury's estimates (which found the proposal to be revenue neutral not including the retaliatory tax burden that would be placed on Michigan's insurance industry by other states), by Pat Anderson's estimates, and by my estimate for the Small Business Association of Michigan. It would not be a proposal that significantly shifts the tax burden away from an industry that is losing jobs and will continue to lose jobs, and creates an enormous tax increase on consumers of insurance and on small business for which insurance is an input into their production process. It would be a proposal that simply cuts taxes.

It is clear that the proposal embodied in SB 296 and HB 4476 reduces taxes substantially on large manufacturing firms and imposes a very large tax increase in the insurance industry. Even if one were to try to put together a revenue neutral tax change in order to increase jobs, this proposal would not be sensible. If we look at long-term trends by industry in Michigan, we can see that average monthly employment in transportation equipment declined from 311.3 thousand in 1990 to 266.6 thousand in 2004. This is a loss of nearly 45,000 jobs. Manufacturing employment as a whole fell by over 130,000 jobs over this period, from 837.6 thousand to 705.6 thousand. This occurred while total

non-farm employment rose by almost 400 thousand jobs, from 3.969 million to 4.368 million. (Department of Labor and Economic Growth, State of Michigan.)

This decline in manufacturing employment is not unique to Michigan, but is rather part of a long-term trend in the United States. Manufacturing as a percent of national value added has declined from 10.2 percent in 1987 to 7.3 percent in 2003. (*2005 Economic Report of the President*.) Durable goods manufacturing payroll jobs declined from a peak of 12.220 million jobs in 1979 to 8.945 million jobs in 2004. This is a decline of 36.6 percent. Over this period nonagricultural payroll jobs increased from 89.932 million to 131.287 million. Thus, manufacturing payroll has declined from 13.7 percent of nonfarm payroll jobs in 1979 to 6.8 percent today. Tuesday, the Purchasing Management Association of Chicago reported that its index of business activity in the Midwest area fell to 54.1 in May from 65.6 in April. In April, the index had fallen from 69.2 in March. A reading above 50 indicates expansion in the manufacturing sector, while a number below 50 indicates contraction. Market forces are reducing the size of the manufacturing sector in Michigan and the United States, and government will not be able to overcome this trend.

These figures ought to indicate if Michigan is to increase its economic growth and employment, it is unlikely that the manufacturing sector will be the engine for growth. While it is possible that manufacturing will lead Michigan's economy forward, it would have to go against the long-term trend both nationally and in Michigan. Employment is even less likely to expand than is value added, since productivity gains in manufacturing are outpacing gains in sales.

The proposal in SB 296 and HB 4476 simply does not make sense from a job creation perspective. Take, for example, one its major components, the personal property tax credit for industrial processors. When a service sector firm, say a real estate agency, adds jobs it typically adds personal property. It must add a desk, chair, phone, computer, etc. In most cases personal property is a complementary factor to labor. On the other hand, manufacturing typically uses personal property to replace labor. If you were constructing a tax proposal to increase jobs, you would give a personal property tax credit to real estate firms rather than manufacturing firms. But this is just the opposite of what the Governor's proposal would do.

Finally, I would like to address one of the major tax increases in SB 296 and HB 4476, the 2 percent sales tax on insurance premiums. This is a major tax increase that will be borne substantially by Michigan's consumers and businesses. I would like to address the issue of the relative tax burden of Michigan's insurance industry and analyze the incidence of the proposed tax.

Discussion of the proper method of the taxation of insurance companies in Michigan has a long history. For those interested in the details of the last debate over the issue, which occurred in 1985-87, and which resulted in the taxation of insurance companies within the Single Business Tax (SBT), I suggest my paper in the 1988 *Detroit College of Law Review*, "Taxation of Insurance Companies in Michigan: Court Cases and the Legislative

Debate." The conclusion of this debate was that the proper taxation of insurance activity in Michigan was taxation of value-added of insurance within the Single Business Tax.

If we look at the statute it is clear that the insurance industry must pay a higher tax on its value-added than other industries. This is because the tax base of insurance companies, while it appears as a percentage of adjusted receipts, is in fact the industry's value added. While serving as the Senior Economist to the Senate Majority Policy Staff, I was intimately involved in the drafting of the language of the 1987 amendatory act. The theoretical basis for determining the value added of an insurance company was grounded in a 1983 *National Tax Journal* article, and uses the subtractive method of determining the base rather than the additive method. The base, as found in Section 22a, is .25 times the adjusted receipts of an insurance company. This is a simplified calculation that approximates the value added of insurance companies. To this base is applied the rate of the SBT that is common to all companies.

Section 22b of the Act applies a surcharge solely on insurance companies that is 1.26 times their calculated tax liability. This means that the industry pays a tax on its value added that more than doubles the tax relative to other industries. There is a credit that can be applied to this surcharge in Section 22c, however, these credits are for payments into government mandated programs, such as the guarantee associations, which are in effect other taxes on insurance companies. In addition, there is a provision that limits the credits to an amount that would leave the tax liability of domestic insurance companies at least \$30 million. Insurance is the only industry that guarantees the state treasury \$30 million in revenue. Thus, the statutory provisions of the SBT ensure that insurance companies pay a higher share of value added than other industries.

The data reflect this fact. The available data on states that most closely resembles state value added is Gross State Product, as calculated by the Bureau of Economic Analysis of the U.S. Government. The most recent available data are for the year 2002. In that year, total Gross State Product for Michigan was \$351.287 billion. The Gross State Product of the insurance industry was \$7.347 billion. Thus, insurance companies comprised 2.1% of Gross State Product. Total SBT collections, including all taxes on insurance companies, were \$2.21 billion in FY 2002. The insurance tax collections were \$227 million. Thus, insurance companies paid 10.3% of the state's business tax, nearly five times its share of Gross Domestic State Product.

While it is odd to compare the tax liability of an industry to something other than the base of the tax in question, I offer some other observations. The insurance industry in Michigan in the same year, 2002, had 1.4% of the non-farm payroll jobs in the state. So its share of the business taxes was several times its share of employment. The same is true of total compensation, where the insurance companies had 1.7% of the compensation.

It is not possible to compare the insurance industry's tax liability to its profits, since insurance companies do not report profits to the Department of Treasury. In addition, it is not clear how insurance companies would reasonably apportion their nationwide

profits to Michigan. In addition, it seems rather silly to make the comparison, since the SBT is not a profits tax. However, individual insurance companies may offer to the committee an estimate of their SBT liability relative to their profits.

Comparing the tax on Michigan's insurance industry to insurance taxes in other states is a rather spurious comparison as well. First, it is not apparent that it is a bad thing that Michigan consumers and businesses to pay a tax on their insurance premiums that is lower than is the case in competitor states. It is likely that half or more of property-casualty premiums are business-related. To the extent that these premiums are taxed at a lower rate than Indiana, business costs in Michigan will be lower.

Who would pay the insurance premiums tax as proposed in SB 296 and HB 4476? It has been suggested that this tax would be paid entirely by the insurance companies. As any economist would tell you, this simply cannot be. In order for this to be the case, the demand for insurance as a whole would have to be perfectly elastic. This is shown in the diagram below, where S represents the market supply of insurance and D represents the market demand. If a 2 percent tax is placed on insurance premiums as suggested by SB 296 is imposed it will result in an upward shift in the supply curve by the amount of the tax, labeled as  $S_t$ . The only way this can not result in an increase in the market price is for the demand curve to be perfectly horizontal as shown in Figure A.

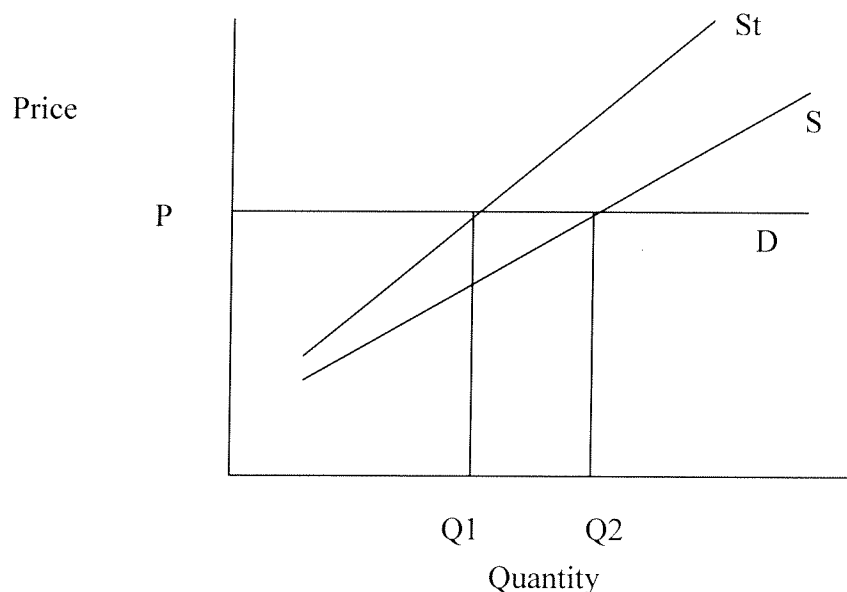


Figure A

This would be a highly unusual market demand curve, not likely to exist in practice. Now consider whether the demand for insurance is instead likely to be highly inelastic. Since Michigan requires all drivers to purchase auto insurance, and most homeowners and businesses that have loans or mortgages are required by their lenders to have homeowners or other property insurance, the demand for insurance is likely to be highly inelastic. Indeed, the demand could very well be perfectly inelastic as shown in Figure B.

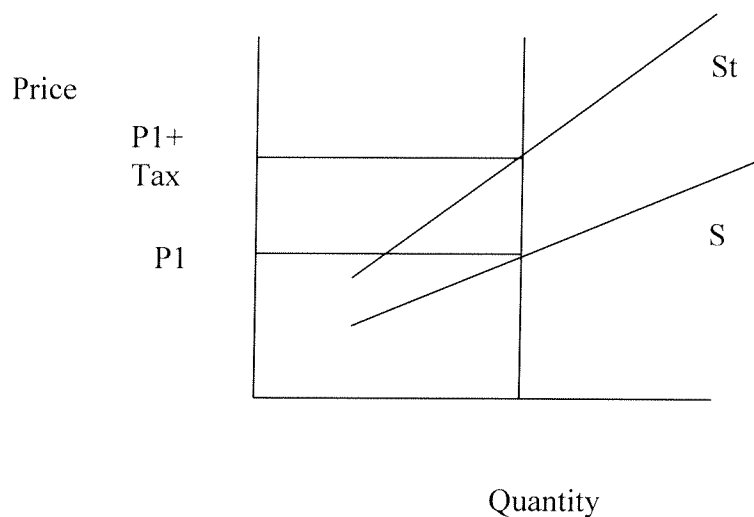


Figure B

As can be seen in Figure B, where  $S$  represents supply,  $S_t$  is the supply after the imposition of a 2 percent tax, and  $D$  represents demand for insurance, the imposition of the tax results in an increase in price that is exactly the amount of the tax. Thus the tax is fully passed on to the purchasers of insurance. As I noted before, the most likely scenario is that the demand for insurance is highly inelastic, at least for property and casualty insurance, and thus it is very likely that most of the burden of a 2 percent sales tax on premiums will be passed on to business and consumers. Since insurance is an input into the production of most businesses, the tax on insurance premiums will result in an increase in the marginal cost of doing business, thus reducing output and decreasing the use of labor and capital in Michigan. This analysis is standard and can be found in any public finance text or most intermediate microeconomics texts. (See, for example, R. Pindyck and D. Rubinfeld, *Microeconomics*, 6<sup>th</sup> edition, Prentice Hall, 2005, page 329.)

Notice that the majority of Michigan's small businesses do not meet the gross receipts threshold for filing for SBT. For a large number of the 100,000 or so firms that file and have some tax liability, the net tax effect will be small. This means that the Governor's tax proposal will primarily have the effect of raising their insurance premiums.

In summary, the tax changes in SB 298 and HB 4476 will raise taxes in Michigan and reduce economic activity. In particular they will harm expanding industries relative to contracting industries. Given Michigan has very high unemployment and the lowest

growth in personal income in the country, that the Pacific Research Institute in its "Economic Freedom Index" ranked Michigan 34<sup>th</sup> among the states, and that Michigan's outbound traffic in the United Van Lines survey composed 69 percent of all of Michigan's interstate moves, the highest its been since 1982, the correct tax policy is to simply reduce taxes on business activity. Governments are not more successful than free markets in picking which industries are going to be favored by consumers. A massive tax shift that favors some industries over others and raises the overall tax burden of Michigan's businesses simply cannot increase economic activity and job growth.